EDITOR'S NOTE

THE FOLLOWING PAGES WERE POOR HARD COPY AT THE TIME OF FILMING. IF AND WHEN A BETTER COPY CAN BE OBTAINED, A NEW FICHE WILL BE ISSUED.

Supreme Court, U.S.
FILED

(1)

97 1794 APR 30 1998

NO.

OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1997

--oo0oo--

HARV L. JEPPSEN,

Petitioner,

-vs-

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

---

PETITION FOR WRIT OF CERTIORARI

Bill Thomas Peters*
Parsons, Davies, Kinghorn & Peters
185 South State Street, Suite 700
Salt Lake City, Utah 84111
Telephone: (801) 363-4300
Counsel for Petitioner
*Counsel of Record

71PP

QUESTION PRESENTED FOR REVIEW

I. SHOULD CERTIORARI BE GRANTED TO REVIEW THE COURT OF APPEALS' ABROGATION OF THIS COURT'S INTERPRETATION OF INTERNAL REVENUE CODE § 165, IN *UNITED STATES v. S. S. WHITE DENTAL MFG. CO.*, 274 U.S. 398 (1927), WHICH ESTABLISHED THAT A TAXPAYER DOES NOT HAVE THE BURDEN TO PROVE NO POSSIBILITY OF EVENTUAL RECOUPMENT IN SHOWING NO REASONABLE PROSPECT OF RECOVERY FOR A THEFT LOSS?

II. SHOULD CERTIORARI BE GRANTED TO REVIEW THE COURT OF APPEALS' ADOPTION OF A LEGAL STANDARD REQUIRING A TAXPAYER TO PROVE THAT A THEFT LOSS COULD NEVER BE RECOVERED AS OF THE END OF THE TAX YEAR IN WHICH THE LOSS WAS DISCOVERED?

III. SHOULD CERTIORARI BE GRANTED TO REVIEW THE COURT OF APPEALS' RULING DISREGARDING UNCONTRADICTED EVIDENCE AS TO THE CERTAINTY THAT REIMBURSEMENT WOULD NOT BE OBTAINED, AS OF THE END OF THE TAX YEAR IN WHICH THE LOSS WAS DISCOVERED?

PARTIES TO THE PROCEEDING

Harv L. Jeppsen, a citizen of the United States of America and a resident of the State of Utah.

The Commissioner of Internal Revenue

TABLE OF CONTENTS

OPINIONS BELOW 1

JURISDICTION 1

STATUTORY PROVISIONS 2

REASONS FOR GRANTING THE PETITION 12

ARGUMENT 13

I. UNDER THE CLOSED TRANSACTION DOCTRINE, PETITIONER'S BURDEN IS NOT TO SHOW THAT THE LOSS WILL NEVER BE RECOVERED; *WHITE DENTAL* REQUIRES ONLY THAT PETITIONER DEMONSTRATE THAT NO REASONABLE PROSPECT FOR RECOVERY EXISTS. 13

II. THE TENTH CIRCUIT IMPROPERLY IGNORED UNCONTROVERTED EVIDENCE THAT THERE WAS NO REASONABLE PROSPECT OF RECOVERY AS OF DECEMBER 31, 1987 17

CONCLUSION 21

TABLE OF CONTENTS

Appendix A:
Order Denying Petition for Rehearing A1-2

Appendix B:
Jeppsen v. Commissioner of Internal Revenue,
128 F.3d 1410 (10th Cir. 1997) B1-28

Appendix C:
Memorandum Findings of Fact and Opinion,
T.C. Memo, 1995-342, filed 07/26/95 . . . C1-14

TABLE OF AUTHORITIES

Cases:

Ansley v. Commissioner of Internal Revenue,
217 F.2d 252 (3d Cir. 1954) 18, 19

Jeppsen v. Commissioner of Internal Revenue,
128 F.3d 1410 (10th Cir. 1997) 1, 12-14, 16, 19, 20

National Labor Relations Board v. Klaue,
523 F.2d 410, 414 (9th Cir. 1975) 21

Rawdon v. Stanley,
455 F.2d 482, 484 (10th Cir. 1972) 20

United States v. Johnson,
208 F.2d 729 (5th Cir. 1953) 20

United States v. S.S. White Dental Mfg. Co.,
274 U.S. 398, 47 S.Ct. 598, 71 L.Ed. 1120 (1927)
. . . . . 12, 13

White Glove Building Maintenance, Inc. v. Brennan,
518 F.2d 1271, 1273 (9th Cir. 1975) 21

TABLE OF AUTHORITIES

Statutes:

26 U.S.C. § 165 . . . . . 2, 13

26 U.S.C. § 7442 4

26 U.S.C. § 7482 4

28 U.S.C. § 1254 1

Rules:

Fed. R. Civ. P. 11 16

Other Authority:

26 C.F.R.§ 1.165-1 . . . . . 2, 3

Harv L. Jeppsen ("Petitioner") hereby petitions for a writ of certiorari to review the judgment of the Tenth Circuit Court of Appeals in this case.

OPINIONS BELOW

The Order of the Tenth Circuit Court of Appeals denying Petitioner's Petition for Rehearing, dated January 30, 1998, is included as Appendix A, pages A-1-A-2. The opinion of the Tenth Circuit Court of Appeals is reported at 128 F.3d 1410 (10th Cir. 1997) and is included as Appendix B at pages B-1- through B-28 (appendix copy includes page citations to Federal Reporter). The Final Decision of the United States Tax Court, entered December 20, 1995, is not reported and is included as Appendix C at pages C-1 through C-14.

JURISDICTION

The opinion of the Tenth Circuit Court of Appeals was entered October 31, 1997. Petitioner timely filed a Petition for Rehearing on November 14, 1997, which was denied by order of the Tenth Circuit Court of Appeals, by Order dated January 30, 1998. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254.

STATUTORY PROVISIONS

Internal Revenue Code of 1986 (26 U.S.C.):
§ 165 LOSSES.

(a) General rule.-- There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(e) Theft losses. -- For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

Treasury Regulations on Income Tax (26 C.F.R.):

§ 1.165-1 LOSSES.

* * *

(d) Year of deduction. (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. For provisions relating to situations where a loss attributable to a disaster will be treated as sustained in the taxable year immediately preceding the taxable in which the disaster actually occurred, see section 165(h) and § 1.165-11.

(2)(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

* * *

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see § 1.165-8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be

received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.

STATEMENT OF THE CASE

Jurisdiction of the United States Tax Court was properly invoked pursuant to 26 U.S.C. § 7442. Jurisdiction of the Tenth Circuit Court of Appeals was invoked by Petitioner pursuant to 26 U.S.C. §-7482.[1]

The Petitioner initiated this action on or about November, 25, 1992, seeking a redetermination of the deficiencies set forth in the notic ; of deficiency issued by the Commission of Internal Revenue, dated August 31, 1992. The taxes in dispute are income taxes for the year 1987, in the amount of $61,297.78.

In February or March of 1986, the Petitioner opened an investment account with E.F. Hutton, through its broker, George A. Barker. Petitioner was an unsophisticated investor and had no prior securities experience. Barker falsified Petitioner's net worth, income, and assets on the new account form and had Petitioner sign documents to set up a discretionary account. Barker took

---

[1] Hereafter, Title 26 of the United States Code shall be referred to as the Internal Revenue Code or simply as the "IRC."

these actions to enable himself to "churn" Petitioner's account for Barker's own profit.

Barker began churning Petitioner's account immediately at E.F. Hutton, with purchases of "calls", which carry higher commissions than ordinary stock trades, and placed Petitioner on a margin account. When Barker left E.F. Hutton and began employment with Piper Jaffrey & Hopwood ("PJH"), he induced Petitioner to transfer his account there. During his employment with PJH, Barker, continued to churn the account and invest in highly speculative securities, without the informed consent of the Petitioner.

In July of 1987, Petitioner learned for the first time that Barker had opened a margin account and learned for the first time the nature of a margin account. Despite Petitioner's instructions to liquidate and close the margin account immediately, Barker continued to make trades out of the account. Petitioner made another demand that Barker close the margin account in August or September of 1987, but Barker failed to comply.

On or about October 7, 1997, Petitioner specifically instructed Barker to immediately liquidate his entire PJH account, with the exception of a mutual fund. Barker agreed to do so, but informed Petitioner that it would take several days to complete the liquidation.[2] During this

---

[2] In fact, as the IRS acknowledged below, the account could and should have been liquidated in one day. *See* Tax

liquidation of Petitioner's account, Barker tried to sell a "call option." Because of its sophisticated nature, the call option is regarded as an extremely risky transaction and Barker's actions were questioned by PJH's Minneapolis office, which requested a special written authorization from Petitioner before it would consummate the transaction. Petitioner was out of town when Barker tried to obtain the special authorization and, rather than wait for Petitioner to return and obtain his signature, Barker forged Petitioner's name on the authorization and altered other documents in Petitioner's file to falsely reflect that Petitioner's authorization had been obtained.

As a result of Barker's actions, the Petitioner lost approximately $166,000 during 1987 and only became aware of the extent of his losses after October 19, 1987 ("Black Monday"), when the Dow Jones Industrial Average decreased in value by 22.6%.

On October 26, 1987, in a meeting with the PJH branch manager, Don Larkin, Petitioner was verbally advised that Barker had acted improperly and that Barker would be reprimanded for his actions in connection with the Petitioner's account. Notwithstanding Larkin's verbal representations to Petitioner, after Petitioner's meeting with Larkin, PJH denied any liability for Petitioner's losses, attributing Petitioner's losses to general market conditions existing at the time and to Petitioner's alleged aggressive investment goals as conveyed to Barker, and

---

Court Decision, Appendix C, p. C-5.

specifically denied any wrongdoing on the part of Barker or that Barker had been reprimanded in any way by PJH for his conduct relative to Petitioner's account.

In October 1987, Petitioner first approached an attorney about the possibility of an action against PJH and/or Barker to recover his losses. That attorney's investigation resulted in a letter dated December 21, 1987, in which PJH's attorney formally denied all liability and formally advised Petitioner that PJH would stand behind its broker, blaming the losses on Petitioner's aggressive investment strategies.

In December of 1987, Petitioner contacted the law firm of Callister, Duncan & Nebeker, the second legal opinion he had sought, regarding representation in an action to recover Petitioner's securities losses. The firm declined to represent the Petitioner on a contingency fee basis and required payment on an hourly basis. The attorneys advised Petitioner that recovery would involve protracted and expensive litigation; that because Petitioner's losses were discovered, and some occurred, at about the time of Black Monday, Petitioner would not be viewed sympathetically by an arbitration board of securities dealers; and that, unless discovery unearthed corroborating documentation, the final determination of liability would rest on who the fact-finder believed -- Petitioner, an investor who had lost $166,000 playing the stock market, or Barker, a stock broker, employed by PJH, a reputable, national brokerage house.

During the hearing before the Tax Court, David W. Scofield, the attorney who was primarily responsible for litigating Petitioner's claims through judgment, testified that, after analyzing Petitioner's claims, the firm was concerned that prosecuting the claim would come down to the Petitioner's word against Baker's word and that, in the context of the "stock market crash" of October 1987, the Petitioner would be seen as merely a disgruntled investor who had lost money along with numerous other investors. This was a compelling impediment to recovery because Petitioner's account agreement contained an arbitration clause which mandated that the resolution be resolved before a panel of arbitrators of the National Association of Securities Dealers, a forum far more advantageous to PJH and Barker. Discovery in that forum would not afford Petitioner the opportunity for full discovery needed to substantiate Petitioner's claims.[3]

During the hearing before the Tax Court, Petitioner testified that, despite the almost insurmountable obstacles and enormous expense, he decided to go forward with the litigation because he felt he had been wronged by Barker and PJH. Suit was filed by petitioner in March of 1988 to recover his losses in federal district court. The defendants sought to dismiss the federal court proceedings and have the matter resolved in the more amenable NASD

---

[3] The nature of Barker's wrongful conduct was so egregious that Petitioner's legal counsel believed there was a distinct possibility that documents which would support Petitioner's claims had or would be destroyed.

forum. In connection with that issue, Petitioner's counsel was successful in conducting discovery in an attempt to establish that the arbitration clause should not be enforced. That effort was ultimately unsuccessful, but did allow Petitioner to obtain information through discovery that he would not otherwise have been able to obtain.

Arbitration proceedings were initiated in December 1989. On January 11, 1994, the Arbitration Panel rendered judgment in favor of Petitioner. That judgment was appealed to and affirmed by the District Court. Appeal was taken to the Tenth Circuit Court of Appeals. However, before the Tenth Circuit rendered a decision, a settlement between the parties was reached.

Based upon all of the facts and circumstances, as they existed as of December 31, 1987, Petitioner claimed a theft loss deduction in the amount of $166,627 on his 1987 federal income tax return, relating to his losses. It is undisputed that the actions of Petitioner's broker, Barker, constituted a "theft" within the meaning of Utah law. At the hearing before the IRS Commissioner, Scofield testified that there was virtually no possibility of recovery as of December 31, 1987, because (1) PJH and Barker were denying any liability for Petitioner's losses, claiming that Barker had complied with Petitioner's instructions and aggressive investment strategies, which instructions and strategies were the cause of his losses; (2) the arbitration clause would likely force Petitioner to press his claims in an unfriendly forum with limited discovery; and (3) thousands of other investors had lost millions of dollars during the time that Petitioner discov-

ered the theft, which would make it less likely, especially in NASD proceedings, that Petitioner would be viewed as anything other than a disgruntled investor.[4]

Scofield's testimony as to the "reasonable possibility of recovery," was unchallenged. Notwithstanding, the Commissioner of the IRS disallowed that deduction on the grounds that Petitioner had a "reasonable prospect" of recovering his loss as of the end of 1987. The Tax Court upheld the determination of the Commissioner. While acknowledging that the securities losses constituted a loss arising from theft, the Tax Court determined that (1) the transaction was not "closed and completed" as of December 31, 1987, and (2) the Petitioner had a "reasonable

---

[4] Scofield testified that, in analyzing the causes of action available to Petitioner, he necessarily assumed that his client was telling the truth -- that Barker had exercised unauthorized control over Petitioner's account by churning the account so as to generate commissions for himself, rather than to maximize Petitioner's investment profits; that Barker failed to liquidate the account when instructed to do so; that Barker forged Petitioner's name; and, significantly, that Barker ignored Petitioner's stated conservative investment goals, had purchased high risk securities to maximize commissions, and lied about Petitioner's instructions and goals after Petitioner discovered he had sustained substantial losses as a result of Barker's wrongful conduct. Legal counsel's assumption does not translate to proof and, against the backdrop of Black Monday, Scofield did not believe Petitioner would prevail in arbitration proceedings.

prospect of recovery" as of December 31, 1987; thus Petitioner could not claim the deduction.

The Tenth Circuit affirmed the decision of the Tax Court, holding that Petitioner had a "reasonable prospect of recovery" as of December 31, 1987:

> Given the facts of this case, including the amount of money at stake, the assets available to the co-defendants and the possibility of obtaining some form of legal restitution, it could not be ascertained with reasonable certainty in 1987 that reimbursement for [Petitioner's] losses would never be obtained. Yet such reasonable certainty is required by Treasury Regulation § 1.165-1(d)(3) in order for a taxpayer to be allowed to deduct a theft loss from taxable income.

REASONS FOR GRANTING THE PETITION

The decision of the Tenth Circuit Court of Appeals directly contradicts this Court's interpretation of IRC § 165 announced in *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398, 47 S.Ct. 598, 71 L.Ed. 1120 (1927). In *White Dental*, this Court determined that

> a loss may be complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. . . . The Taxing Act does not require the taxpayer to be an incorrigible optimist.

Id. at 402-03.

In deciding this case, the Tenth Circuit held that Petitioner "must prove that it could have been ascertained with reasonable certainty as of December 31, 1987 that this loss **would never** be recovered." *Jeppsen*, 128 F.3d at 1418 (emphasis added). Application of this standard renders IRC provisions regarding deduction of theft losses a nullity, in that it can **never** be ascertained that a theft loss will **never** be recovered. Applying this test, the Tenth Circuit, reasoned that, if Petitioner's prospects of recovery were simply unknown at the end of 1987, even though extremely remote, he would not be entitled to take the deduction. *Id.*

By imposing upon Petitioner the burden of showing that the theft loss would never be recovered, the Tenth

Circuit ignored the standard established by this Court in *White Dental*.

ARGUMENT

I. UNDER THE CLOSED TRANSACTION DOCTRINE, PETITIONER'S BURDEN IS NOT TO SHOW THAT THE LOSS WILL NEVER BE RECOVERED; *WHITE DENTAL* REQUIRES ONLY THAT PETITIONER DEMONSTRATE THAT NO REASONABLE PROSPECT FOR RECOVERY EXISTS.

At issue in this case is the Tenth Circuit's attempt to redefine the "closed transaction doctrine." Under IRC § 165, a taxpayer may deduct a theft loss in the year it is "sustained." A theft loss is not necessarily "sustained" when it is discovered for purposes of § 165 if, at the time the loss is discovered, the taxpayer has a "reasonable prospect of recovery." As correctly noted by the Tenth Circuit, the "reasonableness" of the taxpayer's prospects is largely an objective test, "although a court may consider to a limited extent evidence of the taxpayer's subjective contemporaneous assessment of his own prospect of recovery." *Jeppsen*, 128 F.3d at 1418.

Assessing Petitioner's prospects for recovery, the Tenth Circuit noted:

> We appreciate the substantial risk that Jeppsen faced, and the significant effort that

> was required in order for Jeppsen to recover his stolen money. Indeed, faced with such obstacles, Jeppsen might reasonably have had decided to abandon his claims against Barker et al. in 1987. However, Jeppsen did not abandon his claims, in 1987 or ever.

Id. at 1419.

Although the Tenth Circuit acknowledges that the risks and obstacles to recovery were daunting and, indeed, acknowledges that Petitioner would have been justified in abandoning his claim, the majority opinion ignores the Petitioner's testimony that he pursued the claim as a moral imperative, knowing that he had little, if any, chance of succeeding, a fact not overlooked in the dissenting opinion. *Id.* at 1421.

The Tenth Circuit, in its majority opinion, altered the burden Petitioner was required to meet in that it changed the required showing from lack of a reasonable prospect of recovery, to an affirmative proof of a negative -- that reimbursement would never be received. Again referring to the dissenting opinion:

> The merits of the case depended not only upon credibility, but also a determination of whether PJ & H could be responsible for the activities of its broker. PJ & H denied liability and responsibility for its broker, despite an admission by the branch manager that the unauthorized discretionary trading was im-

proper. The parties have stipulated that the broker's actions constituted theft under Utah law, and only if taxpayer could prove that the broker's conduct was in the course and scope of his employment would there be vicarious liability based upon respondeat superior. See Jackson v. Righter, 891 P.2d 1387, 1391 (Utah 1995); Birkner v. Salt Lake County, 771 P.2d 1053, 1056- 59 (Utah 1989). Several courts have held that employee theft is not within the course and scope of employment, see, e.g., Los Ranchitos v. Tierra Grande, Inc., 116 N.M. 222, 861 P.2d 263, 268 (1993); B.B. Walker Co. v. Burns Int'l Security Servs., 108 N.C.App. 562, 424 S.E.2d 172, 174, review denied, 333 N.C. 536, 429 S.E.2d 552 (1993); but see Richards v. Attorneys' Title Guaranty Fund, Inc., 866 F.2d 1570, 1572-73 (10th Cir.) (applying Restatement (Second) of Agency § 261 (1958): vicarious liability for agent's theft), cert. denied, 491 U.S. 906, 109 S.Ct. 3189, 105 L.Ed.2d 697 (1989), and the Utah courts have recognized that the issue may be decided as a matter of law when the employee's conduct is so clearly outside the scope of employment that reasonable minds could not differ, see Jackson, 891 P.2d at 1391; Birkner, 771 P.2d at 1057. Given the parties stipulation of theft, the taxpayer had a formidable legal barrier to overcome.

> As of December 1987, PJ & H also could be expected to defend on the basis that (1) the taxpayer was a sophisticated, aggressive investor who authorized the transactions and sought return without regard for risk, (2) the taxpayer had received confirmations and account statements and therefore had ratified the transactions, and (3) the taxpayer was merely trying to avoid the consequences of the 1987 market fall. I am persuaded that all of these objective factors viewed as of December 1987, together with the taxpayer's statement on cross-examination that he pursued the matter as a moral issue, despite advice that his chances were not very good, Aplt.App. at 155, render the Tax Court's finding clearly erroneous.

Id.

The Tenth Circuit adopted the reasoning of the IRS, which confuses the availability of numerous theories of liability, and the ability of Petitioner to advance them under Fed. R. Civ. P. 11, with having available sufficient evidence to have any prospect of sustaining his burden of proof with respect to **any** of those theories, or a reasonable likelihood that he would be able to obtain such evidence, given the facts and circumstances of the case, the time frame during which Petitioner's claims arose, and the mandatory arbitration forum. Indeed, it was not until Petitioner received an arbitration award that the IRS even

would concede there was a theft. Until that time, the IRS itself entirely disputed Petitioner's claim.[5]

II. THE TENTH CIRCUIT IMPROPERLY IGNORED UNCONTROVERTED EVIDENCE THAT THERE WAS NO REASONABLE PROSPECT OF RECOVERY AS OF DECEMBER 31, 1987

Like the Tax Court before it, the Tenth Circuit totally ignored the uncontroverted testimony of Mr. Scofield, Petitioner's attorney in the securities fraud case, who testified:

> Well, [during the January 1988 meetings with Petitioner], Mickey Duncan and I were very concerned that coming out of this stock market crash an investor claiming unauthorized transactions would be viewed as simply a disgruntled investor, and if we were to go before an industry arbitration panel, it would, basically, come down to the investor's word against the broker's word. And in a post-crash case, we felt there was virtually no chance of success without the opportunity to do discovery in hopes of developing a record

---

[5] The Commissioner initially determined that Petitioner's losses were capital losses rather than theft losses. *See* Petition for Redetermination filed by Petitioner on November 25, 1992.

> through which we could impeach the broker's credibility on these issues. And if we went to arbitration, it was our feeling we would not have the opportunity to do discovery that would be adequate to prove the case.

Scofield's testimony was unchallenged by the IRS. Neither the Tax Court nor the Tenth Circuit accepted Scofield's testimony and neither court gave any reason for rejecting it. A court may not stubbornly ignore and refuse to be guided by competent, credible, and uncontradicted evidence when all reasonable minds would accept it, without setting forth any basis for rejecting that evidence. The Third Circuit Court of Appeals addressed the issue in *Ansley v. Commissioner of Internal Revenue*, 217 F.2d 252 (3d Cir. 1954). In that case, the Tax Court had ruled that, partially because there was no appraisal or other evidence of value regarding the subject corporate stock, the taxpayer had not carried his burden regarding the date when his capital stock became worthless.[6] The Third Circuit held:

> In stating that there was no appraisal or evidence of value, the Tax Court disregarded the positive and affirmative testimony of the taxpayer and the disinterested trustee. Their uncontradicted testimony was inherently be-

---

[6] The issue in the *Ansley* case was whether the taxpayer was entitled to deduct the loss attributable to his capital stock as an ordinary loss or a short term capital loss.

> lievable. The short time interval between the end of 1947 and the final decision of the creditors on January 8, 1948, to liquidate the corporation, followed by the adjudication in bankruptcy on February 14, 1948, lends additional credence to their testimony. In such a situation, the Tax Court was bound to accept the testimony, which showed beyond doubt the stock's worthlessness in 1947. [Citations omitted.]

Id. at 257.

Scofield's testimony was pivotal and established, beyond doubt, that there was no "reasonable prospect of recovery" as of December 31, 1987. As the dissenting opinion of Judge Kelly in the *Jeppsen* case cogently notes:

> Surely a "reasonable prospect of recovery" encompasses an assessment of litigation risk at the time the deduction is claimed; given the uncertainty of trial and proof, there is a world of difference between pleading a claim, proving it and bringing it to judgment. Moreover, the obvious defenses to a claim cannot be ignored, nor can the financial capacity of a defendant to vigorously contest liability. At the Tax Court trial, **the only testimony about the mechanics of the taxpayer's claim and the defenses raised was the attorney who prosecuted the claim, an expert in the field**

> **of securities litigation. No persuasive reason exists for disregarding his testimony.** See Ramsay Scarlett, 521 F.2d at 789 (Widener, J., concurring) ("The opinion of Sykes, admittedly a skillful attorney, as to the merits of the taxpayers' claims against the bank, was obviously relevant in any kind of objective inquiry."). Although the government, with 20-20 hindsight, suggests various theories of liability that should have been apparent in 1987, most of the telling facts were developed later and the difficulty of successful proof on controverted facts makes the outcome far less apparent. See, e.g., Hotmar v. Lowell H. Listrom & Co., 808 F.2d 1384, 1385 (10th Cir.1987) (directed verdict in favor of defendants on churning claim).

128 F.3d at 1421 (emphasis added).[7]

---

[7] *See also United States v. Johnson*, 208 F.2d 729, 730 (5th Cir. 1953) (where the testimony of the witness was unimpeached and uncontradicted, and its credibility was in no manner brought into question, the court could not reject such testimony); *Rawdon v. Stanley*, 455 F.2d 482, 484 (10th Cir. 1972) (unimpeached credible evidence may not be disregarded by the trier of fact); *White Glove Building Maintenance, Inc. v. Brennan*, 518 F.2d 1271, 1273 (9th Cir. 1975) (fact finder is not at liberty to disregard, without explanation, uncontradicted testimony of witness whose testimony was clear, positive and unimpeached, and rejection of such evidence without detailed explanation of reasons for rejection was improper as being

In the absence of any articulated reason for rejecting the only evidence regarding Petitioner's prospects for recovery, offered by a disinterested party and totally unchallenged by the IRS, this Court should grant certiorari to review the Tenth Circuit's decision.

CONCLUSION

The Tenth Circuit's decision imposes an impossible and incorrect burden of proof on Petitioner in requiring him to establish that there was no possibility his losses would ever be recovered. The appropriate test is whether, under the facts and circumstances existing at the end of the tax year in which the loss was incurred, Petitioner had a "reasonable prospect of recovery" with respect to his losses.

The evidence presented by Petitioner was credible, clear, and uncontradicted. No reason to disregard that evidence was given by either the Tax Court or the Tenth Circuit in affirming the Tax Court's decision.

Petitioner met his burden of proof under the appropriate standard and this Court should grant certiorari and reverse the decision of the Tenth Circuit.

---

arbitrary); *National Labor Relations Board v. Klaue*, 523 F.2d 410, 414 (9th Cir. 1975) (trier of fact may reject uncontradicted testimony, but he may not do so without good reason).

Respectfully submitted.

Bill Thomas Peters*
Parsons, Davies, Kinghorn & Peters
185 South State Street, Suite 700
Salt Lake City, Utah 84111
(801) 363-4300

April 30, 1998

* Counsel of Record

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

HARV L. JEPPSEN,	)	
	)	
Petitioner-Appellant,	)	
	)	
v.	)	NO. 96-9002
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent-Appellee.)		

ORDER

Filed January 30, 1998

Before **EBEL, McWILLIAMS**, and **KELLY**, Circuit Judges.

Harve [sic] L. Jeppsen's petition for rehearing is denied by the panel that rendered the decision.

The suggestion for rehearing en banc was transmitted to all of the judges of the court who are in regular active service as required by Fed. R. App. P.35. No member of the panel and no

judge in regular active service on the court requested that the court be polled on rehearing en banc so the suggestion for en banc rehearing is also denied.

Entered for the Court
PATRICK FISHER, Clerk of the Court

by: /s/ (L. Balzano)
Deputy Clerk

Copr. © West 1998 No Claim to Orig. U.S. Govt. Works
128 F.3d 1410
97-2 USTC P 50,878, 97 CJ C.A.R. 2732

Harv L. JEPPSEN, Petitioner-Appellant,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 96-9002.

United States Court of Appeals,
Tenth Circuit.

Oct. 31, 1997.

Taxpayer challenged denial of income tax deduction for theft loss. The United States Tax Court, 1995 WL 440435, upheld determination, and taxpayer appealed. The Court of Appeals, Ebel, Circuit Judge, held that: (1) settlement reached after close of tax year was not improperly considered in determining whether taxpayer enjoyed reasonable prospect of recovering stolen assets, such that deduction would be unavailable, and (2) taxpayer enjoyed reasonable prospect of recovering stolen assets at close of tax year.

Affirmed.

Paul J. Kelly, Jr., Circuit Judge, filed dissenting opinion.

[1] INTERNAL REVENUE k3417
220k3417
Theft loss is "sustained" not at time theft actually occurs, but rather during when taxpayer discovers such loss, in determining when taxpayer may take income tax deduction. 26 U.S.C.A. § 165(e).

[2] INTERNAL REVENUE k3417
220k3417
Existence of claim of reimbursement with reasonable prospect of recovery will prevent theft loss from being considered as "sustained," as required to qualify for income tax deduction, unless and until it is determined with reasonable certainty that such reimbursement will not be obtained. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165-1(d)(2)(i), (d)(3).

[3] INTERNAL REVENUE k4705
220k4705
Court of Appeals reviews Tax Court's factual findings under clearly erroneous standard and reviews its legal conclusions de novo. 26 U.S.C.A. § 7482(a)(1).

[3] INTERNAL REVENUE k4730
220k4730
Court of Appeals reviews Tax Court's factual findings under clearly erroneous standard and reviews its legal conclusions de novo. 26 U.S.C.A. § 7482(a)(1).

[4] INTERNAL REVENUE k3417
220k3417
Facts that are not reasonably foreseeable as of close of pertinent tax year may not be considered in determining whether taxpayer enjoyed reasonable prospect of recovering stolen assets, such that income tax deduction for theft loss would be unavailable. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165- 1(d)(2)(i), (d)(3).

[5] INTERNAL REVENUE k4656
220k4656
Tax Court could take note of taxpayer's settlement of suit to recover stolen assets, which occurred after close of taxable year in which taxpayer claimed income tax deduction for theft loss, for limited purpose of providing "completeness" to its opinion, so long as it did

not consider settlement in determining whether taxpayer enjoyed reasonable prospect of recovering stolen assets at close of tax year, such that deduction would be unavailable. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165-1(d)(2)(i), (d)(3).

[6] INTERNAL REVENUE k4708
220k4708
On appeal from Tax Court, mixed questions of law and fact are reviewed either under clearly erroneous standard or de novo, depending on whether mixed question is primarily factual or legal.

[7] INTERNAL REVENUE k4731
220k4731
Pursuant to treasury regulations, whether reasonable prospect of recovery exists with respect to claim for reimbursement of loss, such that loss does not qualify for income tax deduction, is question of fact, subject to clearly erroneous standard of review. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165-1(d)(2)(i), (d)(3).

[8] INTERNAL REVENUE k3442
220k3442
Taxpayer bears burden of proving his entitlement to income tax deduction for theft loss, which requires showing that it could have been ascertained with reasonable certainty as of close of taxable year that loss would never be recovered. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165-1(d)(2)(i), (d)(3).

[9] INTERNAL REVENUE k3385
220k3385
Reasonable prospect of recovery of loss exists, precluding income tax deduction, when taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is substantial possibility that such claims will be decided in his favor. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165- 1(d)(2)(i), (d)(3).

[10] INTERNAL REVENUE k3385
220k3385
In determining whether taxpayer has reasonable prospect of recovery of loss, precluding income tax deduction, even small chance of success might make pursuit of legal remedies objectively reasonable, especially when stakes are high. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165-1(d)(2)(i), (d)(3).

[11] INTERNAL REVENUE k3385
220k3385
Reasonableness of taxpayer's prospect of recovery of loss is primarily tested objectively, in determining whether taxpayer qualifies for income tax deduction, although court may consider to limited extent evidence of taxpayer's subjective contemporaneous assessment of his own prospect of recovery. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165-1(d)(2)(i), (d)(3).

[12] INTERNAL REVENUE k3385
220k3385
That taxpayer, in given tax year, contemplates filing suit to recover his losses may be considered in mix of evaluating whether the taxpayer has reasonable prospect of recovery, such that income tax deduction would be unavailable, but like any other subjective factor, this inference should not control outcome of case. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165- 1(d)(2)(i), (d)(3).

[13] INTERNAL REVENUE k3417
220k3417
It could not be ascertained at close of tax year that taxpayer would never obtain reimbursement of investment funds stolen by his broker, and taxpayer was thus not entitled to income tax deduction for theft loss, despite substantial risk that taxpayer faced and significant effort that was required, given amount of funds at stake, taxpayer's swift efforts to procure attorney, his continuing determination to recover funds, assets available to satisfy judgment, and merit to taxpayer's

legal theory. 26 U.S.C.A. § 165(e); 26 C.F.R. § 1.165- 1(d)(2)(i), (d)(3).

*1411 Bill Thomas Peters, Parsons, Davies, Kinghorn & Peters, Salt Lake City, UT, for Petitioner-Appellant.

Sarah K. Knutson, United States Department of Justice, Washington, DC (Teresa E. McLaughlin, United States Department of Justice, Washington, DC, with her on brief), for Respondent-Appellee.

Before EBEL, Circuit Judge, McWILLIAMS, Senior Circuit Judge, and KELLY, Circuit Judge.

EBEL, Circuit Judge.

In 1987, a stockbroker misappropriated $194,000 from petitioner-appellant Harv L. Jeppsen. Jeppsen claimed a deduction for this theft loss on his 1987 federal income tax return. In 1988, Jeppsen began a seven-year litigation campaign to recover his stolen money. In 1992, respondent-appellee Commissioner of Internal Revenue ("the IRS") disallowed Jeppsen's 1987 theft loss deduction, on the grounds that it was reasonably foreseeable by the end of 1987 that Jeppsen would recover the stolen money. Shortly thereafter, Jeppsen challenged this disallowance in tax court.

In March, 1995, Jeppsen's campaign to recover his stolen money achieved fruition, when Jeppsen was awarded almost $1,500,000 in general and punitive damages, interest, attorney's fees, and costs. Four months later, after learning of this award, the tax court agreed with the IRS that Jeppsen was not entitled to the theft loss deduction claimed on his 1987 tax return. Jeppsen appeals the decision of the Tax Court. Because we find that as of December 31, 1987, it could not be ascertained with reasonable *1412 certainty that Jeppsen would not recover his stolen money, we affirm.

BACKGROUND

The facts of the present case are largely undisputed. In February or March of 1986, appellant Harv L. Jeppsen, a self-employed carpet installer and high school graduate, began investing money through George Barker, a securities dealer with the E.F. Hutton Group brokerage firm. Jeppsen v. Commissioner, 70 T.C.M. (CCH) 199, 199, T.C.M. (RIA) ¶ 95,342 (1995), T.C. Mem. No.1995-342, 1995 WL 440435. At that time, Jeppsen had no prior experience investing in stocks or stock options.

Barker, who knew that Jeppsen was not experienced or sophisticated in securities investments, fraudulently established Jeppsen's E.F. Hutton account as a discretionary account in order to authorize Barker to transact securities trades in the account. Shortly thereafter, Barker began to "churn" Jeppsen's investments by purchasing and selling various call options.

In September, 1986, Barker left E.F. Hutton and began working at the brokerage securities firm of Piper, Jaffray and Hopwood, Inc. ("PJ & H"). In December, 1986, Jeppsen transferred his E.F. Hutton account to PJ & H so that Barker could continue to act as his broker. At that time, Barker fraudulently obtained Jeppsen's signature on documents needed to open a PJ & H margin account in Jeppsen's name. In addition, without Jeppsen's permission and without ever obtaining Jeppsen's signature, Barker established Jeppsen's primary PJ & H account as a discretionary account. Barker then invested much of the money in this account in certain "penny stocks" whose price was manipulated by Barker and an accomplice through repeated purchases and sales.

In July, 1987, Jeppsen became aware of Barker's activities, and ordered Barker to close his margin account immediately. Barker failed to close the account. When Jeppsen received his next monthly statement indicating that the margin account had not been closed,

Jeppsen again ordered Barker to close the margin account. Barker again failed to close the account, and continued to execute new transactions in the account.

On October 7, 1987, Jeppsen specifically instructed Barker to immediately liquidate to cash the entire balance of Jeppsen's PJ & H account, except for a mutual fund. Barker did so slowly, forging Jeppsen's signature when necessary to liquidate certain high-risk derivative investments that Jeppsen had never authorized him to make.

On October 19, 1987, a date popularly known as "Black Monday," the Dow Jones Industrial Average decreased in value by 22.6 percent. As a result, Jeppsen's PJ & H account, which had not yet been liquidated, declined in value by approximately $194,000.

The following week, Jeppsen met with PJ & H's branch manager and Barker's supervisor, Don Larkin, to discuss the losses Jeppsen had suffered in his PJ & H account. Larkin initially told Jeppsen that because of the large negative balance in Jeppsen's margin account all securities in his discretionary account would have to be sold to pay Jeppsen's debt to PJ & H. When Jeppsen protested that the trading losses had been caused by Barker's unauthorized activities in Jeppsen's name, Larkin admitted to Jeppsen that Barker's activities had been improper. Larkin then formally reprimanded Barker for the unauthorized discretionary trading in Jeppsen's PJ & H account. Nonetheless, Larkin denied that PJ & H was liable in any way for Barker's actions.

At the end of October, 1987, Jeppsen retained an attorney to investigate Barker's actions with regard to Jeppsen's brokerage accounts at E.F. Hutton and PJ & H. This attorney's inquiries spurred PJ & H's legal counsel to send Jeppsen a letter dated December 21, 1987. The letter denied that PJ & H was in any way responsible for Jeppsen's losses in his PJ & H account, and claimed that Jeppsen was

merely a frustrated investor who had lost money as a result of the October 19, 1987 fall in the stock market.

In December, 1987, a Salt Lake City law firm agreed to represent Jeppsen in an action to recover his losses, but required Jeppsen to pay on an hourly rather than contingency fee basis. The law firm told Jeppsen that he had a chance to win, but that the lawsuit would be long and costly. Jeppsen ***1413** responded that he would nonetheless like to proceed with some type of legal action.

On March 5, 1988, Jeppsen filed suit against Barker, PJ & H, and E.F. Hutton in federal district court in Utah. Jeppsen v. Piper, Jaffray & Hopwood, Inc., 879 F.Supp. 1130, 1132-33 (D.Utah 1995). On May 9, 1988, PJ & H moved to stay proceedings pending arbitration and to compel arbitration.

In July, 1988, while PJ & H's motion was under consideration by the district court, Jeppsen filed his 1987 federal income tax return. On his return, Jeppsen claimed a theft loss deduction in the amount of $166,627 relating to the losses he incurred in 1987 in his E.F. Hutton and in his PJ & H brokerage accounts. [FN1]

> FN1. Jeppsen's theft loss deduction of $166,627 was less than his claimed actual theft loss of $193,712 because the IRS requires actual theft losses to be reduced by ten percent of adjusted gross income, plus $100, prior to being deducted. See 1987 IRS Form 4684 (R. Vol. III Doc. 1).

On December 26, 1989, the district court granted PJ & H's motion to stay proceedings pending arbitration and to compel arbitration. Jeppsen v. Piper, Jaffray & Hopwood, Inc., 879 F.Supp. 1130, 1133 (D.Utah 1995). On December 11, 1991, Jeppsen settled his claims against E.F. Hutton. Around that time, and after Jeppsen had already paid them $180,000, Jeppsen's law firm changed its fee arrangement to a contingency basis.

On August 31, 1992, the IRS mailed Jeppsen a Notice of Deficiency regarding Jeppsen's 1987 federal income tax. (R. Vol. III Doc. J Exh. 2-B). The claimed deficiency of $61,297.78 [FN2] resulted from the IRS's disallowance of Jeppsen's $166,627 theft loss deduction. The IRS disallowed the deduction on the ground that Jeppsen had a reasonable prospect of recovering his loss as of the close of 1987. On November 25, 1992, pursuant to I.R.C. § 7442, Jeppsen filed a petition in the United States Tax Court, challenging the Notice of Deficiency.

> FN2. The IRS also assessed Jeppsen an addition to tax of $9,735 under I.R.C. § 6651, due to Jeppsen's delinquency in paying the deficiency of $61,297.78 which the IRS claimed should have been paid with Jeppsen's 1987 tax return. (R. Vol. III Doc. J Ex. 2-B).

On March 17, 1993, before his tax case was tried, Jeppsen filed his Statement of Claim with the National Association of Securities Dealers, which was to preside over the compelled arbitration against Piper, Jaffray and Barker & Larkin. Jeppsen v. Piper, Jaffray & Hopwood, Inc., 879 F.Supp. 1130, 1133 (D.Utah 1995). A five-day arbitration hearing was held in November, 1993 in Salt Lake City, Utah. On January 20, 1994, the arbitration panel awarded Jeppsen damages of $603,000 (treble damages) plus attorneys' fees and costs of $388,541.55 against PJ & H, Barker, and Larkin, jointly and severally, plus $250,000 each in punitive damages against Larkin and Barker separately and individually. This award, however, was subject to appeal to the federal district court which had ordered the arbitration.

On March 17, 1994, Jeppsen's challenge to the IRS's Notice of Deficiency was tried before the United States Tax Court in Salt Lake City, Utah. At that proceeding, the tax court was apprised that Jeppsen had won an award from the arbitration panel, but that the award was not final because the arbitration defendants still had until

April 18, 1994 to appeal the award to the district court. [FN3] At the conclusion of the two-hour hearing, the tax court requested further briefing from the parties and took the case under advisement.

> FN3. See Jeppsen v. Commissioner, 70 T.C.M. (CCH) 199, 201, T.C.M. (RIA) ¶ 95,342 (1995), T.C. Mem. No.1995-342 (reporting sums awarded to Jeppsen).

On March 6, 1995, while Jeppsen's tax case was still under advisement, the arbitration panel's award in Jeppsen's case against PJ & H, Barker, and Larkin was confirmed by the United States District Court for the District of Utah. Jeppsen v. Piper, Jaffray & Hopwood, Inc., 879 F.Supp. 1130, 1140 (D.Utah 1995). The defendants appealed to the Tenth Circuit, but settled the case in June, 1995, before the appeal was heard. Jeppsen v. Commissioner, 70 T.C.M. (CCH) 199, 201, T.C.M. (RIA) ¶ 95,342 (1995), T.C. Mem. No.1995-342; (Aplt.'s App. at 74). The details of the settlement were confidential.

Shortly thereafter, an IRS attorney notified Jeppsen that the tax court had inquired as to whether a settlement had been reached ***1414** in Jeppsen's case against PJ & H, Barker, and Larkin, and that the IRS had answered the tax court's inquiry in the affirmative. In response to these events, Jeppsen filed a Motion To Strike from the tax court proceedings "any information, evidence, or otherwise before the Court which relates to any result, decision, opinion, or otherwise promulgated by the United States Court of Appeals for the Tenth Circuit, the United States District Court for the District of Utah or the National Association of Securities Dealers, or which relates to any settlement by the parties of any matters pending before such entities and related to [Jeppsen's case against PJ & H, Barker, and Larkin]." (Aplt.'s App. at 72-73.)

On July 24, 1995, the tax court denied Jeppsen's Motion to Strike. In a brief Order, the court stated that it had requested information

regarding the current status of Jeppsen's lawsuits "solely for purposes of completeness." It also noted that "the terms of the settlement of the lawsuit ... were not disclosed to the Court and that the confidentiality of the settlement was not breached." (Aplt.'s App. at 78.)

Two days later, on July 26, 1995, the tax court issued a Memorandum Opinion sustaining the IRS's disallowance of the theft loss deduction Jeppsen claimed for tax year 1987. Jeppsen v. Commissioner, 70 T.C.M. (CCH) 199, 202, T.C.M. (RIA) ¶ 95,342 (1995), T.C. Mem. No.1995-342. Jeppsen now appeals. We exercise appellate jurisdiction pursuant to I.R.C. § 7482(a).

DISCUSSION

Under the Internal Revenue Code, a taxpayer may deduct from taxable income "any loss sustained during the taxable year and not compensated for by insurance or otherwise." I.R.C. § 165(a). Under Section 165(c), such a loss includes "losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from ... theft." I.R.C. § 165(c)(3). The IRS concedes that Barker's actions constitute "theft," and that Jeppsen's loss therefore qualifies as a "theft loss" within the meaning of I.R.C. § 165. (Appellee's Br. at 17). We agree. See Treas. Reg. § 1.165-8(d) (defining theft broadly to include larceny).

[1][2] At issue here is whether Jeppsen's theft loss was "sustained" during tax year 1987. Under the Internal Revenue Code, a theft loss is not "sustained" at the time the theft actually occurs. Rather, "any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss." I.R.C. § 165(e). Further, the Treasury Regulations provide that even after a theft loss is discovered, if a claim for reimbursement exists during the year of the loss with respect to which there is a reasonable prospect of recovery, then a theft loss is treated as "sustained" only when "it can

be ascertained with reasonable certainty whether or not such reimbursement [for the loss] will be obtained." Treas. Reg. §§ 1.165- 1(d)(2)(i), 1.165-1(d)(3); accord Treas. Reg. § 1.165-8(a)(2). In essence, this has been interpreted to mean that the existence of a claim of reimbursement with a reasonable prospect of recovery will prevent a loss from being considered as "sustained" unless and until it is determined with reasonable certainty that such reimbursement will not be obtained. See, e.g. Rainbow Inn, Inc. v. Commissioner, 433 F.2d 640, 643-44 (3rd Cir.1970).

In the present case, based on the evidence before it the tax court found that, as of December 31, 1987, a viable legal claim for reimbursement existed and there was a reasonable prospect that Jeppsen would recover his stolen $194,000. For this reason, the tax court held that Jeppsen did not "sustain" a theft loss in 1987.

Jeppsen claims that the tax court erred in two principal respects. First, Jeppsen claims that the court should not have considered events that transpired after December 31, 1987, in determining whether Jeppsen had a reasonable prospect of recovering his stolen $194,000 by the end of 1987. Second and more fundamentally, Jeppsen claims that the tax court erred in concluding that by the end of 1987 Jeppsen had a reasonable prospect of recovering his stolen $194,000. We consider each of Jeppsen's claims in turn.

I.

[3] We review Tax Court decisions "in the same manner and to the same extent as *1415 decisions of the district courts in civil actions tried without a jury." I.R.C. § 7482(a)(1). Thus, we review the Tax Court's "factual findings under the clearly erroneous standard and review its legal conclusions de novo." Anderson v. Commissioner, 62 F.3d 1266, 1270 (10th Cir.1995). The question whether a court may consider events that transpired after the end of a tax year in order to determine whether, as of the end of that tax year, a taxpayer

enjoyed a reasonable prospect of recovering stolen assets is a question of law which we review de novo.

Although this question appears to be one of first impression in this circuit, it was addressed by the Supreme Court in a case involving a predecessor statute of the current I.R.C. § 165. In United States v. S.S. White Dental Mfg. Co., 274 U.S. 398, 47 S.Ct. 598, 71 L.Ed. 1120 (1927), the taxpayer, a Pennsylvania corporation engaged in the manufacture and sale of dental supplies, had organized a German subsidiary. In 1917, when the United States entered World War I, all assets of the German subsidiary were seized by the German government. Consequently, the taxpayer deducted the value of these assets from its 1918 taxes as an uncompensated loss. In 1924, following Germany's defeat in the War, the taxpayer was awarded partial restitution for its seized losses by the Mixed Claims Commission. Shortly thereafter, although no restitution had yet been paid, the IRS disallowed the taxpayer's 1918 deduction on the grounds that the loss of the German subsidiary had not been a "closed and completed transaction" in 1918, as evidenced by the 1924 restitution award. Id. at 399-400, 47 S.Ct. at 599.

The Supreme Court agreed with the taxpayer's reading of the statute. As the Court explained:

> a loss may be complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. It would require a high degree of optimism to discern in the seizure of enemy property by the German government in 1918 more than a remote hope of ultimate salvage from the wreck of the war. The Taxing Act does not require the taxpayer to be an incorrigible optimist.

Id. at 402-03, 47 S.Ct. at 600.

By rejecting the I.R.S.'s exclusive reliance on events which transpired after 1918 as a basis for disallowing the taxpayer's 1918 theft loss deduction, the S.S. White Dental Mfg. Co. court

established that a taxpayer's ultimate recovery does not control whether, at the end of a taxable year, that taxpayer enjoyed a reasonable prospect of recovering property stolen during that taxable year. However, S.S. White Dental Mfg. Co. did not address the issue of whether the IRS or a court may consider a taxpayer's ultimate recovery as one factor in its assessment of the reasonableness of the taxpayer's ab initio prospect of recovery.

In perhaps the only case from any court to address this distinction directly, the tax court held that ultimate recovery is irrelevant if it was not reasonably foreseeable by the end of the pertinent tax year. The court said:

> this Court must determine what was a "reasonable expectation" as of the close of the taxable year for which the deduction is claimed. The situation is not be viewed through the eyes of the "incorrigible optimist," and hence, claims for recovery whose potential for success are remote or nebulous will not demand a postponement of the deduction. The standard is to be applied by foresight, and hence, we do not look at facts whose existence and production for use in later proceedings was not reasonably foreseeable as of the close of the particular year. Nor does the fact of a future settlement or favorable judicial action on the claim control our determination. if we find that as of the close of the particular year, no reasonable prospect of recovery existed.

Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811-12, 1974 WL 2742 (1974), aff'd, 521 F.2d 786 (4th Cir.1975) (internal citations omitted and emphasis added). Accord Rainbow Inn, Inc., 433 F.2d at 644 ("The test is whether there was a reasonable prospect of recovery at the time the deduction was claimed, not later."); see also Dawn v. Commissioner, 675 F.2d 1077, 1078 (9th Cir.1982) (taking into consideration a lawsuit filed after ***1416** the close of the tax year in which a theft loss deduction was claimed, where it was reasonably foreseeable during the tax year at issue that a lawsuit would later be filed).

[4] Both parties to the present case agree with the court's statement of the controlling legal principles in Ramsay Scarlett, although they disagree regarding the application of those principles to the present facts. We also agree with the court's observation in Ramsay Scarlett that determination of a reasonable prospect of recovery is a question of foresight. See also Parmelee Transportation Co. v. United States, 173 Ct.Cl. 139, 351 F.2d 619, 628 (1965) (the court must assess if a reasonable person would have entertained a reasonable chance of recovery during the year of the discovered loss). Therefore, in accord with the Ramsay Scarlett decision, we hold that neither the IRS nor the tax court may consider in this context facts not reasonably foreseeable as of the close of the pertinent tax year.

[5] Nonetheless, we reject Jeppsen's claim that in the present case the tax court improperly considered evidence of Jeppsen's ultimate recovery. We agree with Jeppsen that evidence of a recovery in 1995 should not have influenced the tax court's ultimate finding regarding the reasonableness, as of December 31, 1987, of Jeppsen's prospect of recovery. We note, however, that the tax court expressly stated that its finding was not influenced by its receipt of such evidence. Indeed, in its July, 24, 1995 Order denying Jeppsen's Motion to Strike, the tax court expressly stated that it had sought information regarding the current status of Jeppsen's lawsuits against PJ & H, Barker, and Larkin, not for any purpose related to the court's decision making process, but rather "solely for purposes of completeness." In the same Order, the tax court also noted that "the terms of the [final] settlement of the lawsuit ... were not disclosed to the Court and ... the confidentiality of the settlement was not breached." (Aplt 's App. at 78.) Thus, although the tax court was privy to the details of the arbitration panel's award to Jeppsen, it never learned how much money Jeppsen actually accepted in order to settle the defendants' appeal to this court.

Two days after denying Jeppsen's Motion to Strike, the tax court issued its Memorandum Opinion in the present case. Jeppsen v.

Commissioner, 70 T.C.M. (CCH) 199, T.C.M. (RIA) ¶ 95,342 (1995), T.C. Mem. No.1995-342. In its "FINDINGS OF FACT," the Memorandum Opinion noted: (1) the terms of the arbitration panel's award to Jeppsen; (2) the fact that the award had been appealed to this court; and (3) the fact that "[b]efore the Tenth Circuit rendered a decision on the appeal, the parties apparently entered into a confidential settlement of the dispute." Id. at 201. In analyzing Jeppsen's substantive claim, however, the Memorandum Opinion nowhere relied on the fact of Jeppsen's ultimate recovery. See id. at 201-02.

We agree with the tax court that a statement of the ultimate disposition of Jeppsen's suits against PJ & H, Barker, and Larkin is helpful to the reader in understanding the facts of the case, and thus contributes to the "completeness" of that court's written Memorandum Opinion. [FN4] Several courts, including the Ramsay Scarlett court itself, have noted the ultimate disposition of the taxpayer's claims for recovery even while discounting the relevance of that fact to the court's ultimate decision. See, e.g. Ramsay Scarlett, 61 T.C. at 805-06, 811-12 (noting that taxpayer obtained partial recovery in 1969 of money embezzled in 1965, but finding that taxpayer had no reasonable prospect of recovery in 1965); Rainbow Inn, Inc. v. Commissioner, 433 F.2d 640, 642 (3d Cir.1970) (finding no reasonable prospect of recovering money embezzled in 1962, even though taxpayer obtained restitution judgment in 1963, where judgment was based on erroneous legal theory and was reversed in 1964). Accordingly, we decline Jeppsen's invitation to read any impropriety into the tax court's decision to note in its opinion, solely for the sake of completeness, the final disposition of Jeppsen's recently-decided lawsuits against PJ & H, Barker, and Larkin.

> FN4. Indeed, we have included a statement regarding Jeppsen's successful recovery in the "BACKGROUND" section of the present opinion.

*1417 II.

We now consider the central issue in the case: whether the tax court erred in its determination that, as of Dec. 31, 1987, Jeppsen had a reasonable prospect of recovering his stolen $194,000. Pursuant to I.R.C. § 7482(a)(1) and Fed.R.Civ.P. 52(a), we review the tax court's factual findings under the "clearly erroneous" standard. Anderson v. Commissioner, 62 F.3d 1266, 1270 (10th Cir.1995). We review the tax court's legal conclusions de novo. Id.

[6] We review mixed questions of law and fact either under the clearly erroneous standard or de novo, depending on whether the mixed question is primarily factual or legal. Id. Where, as here, the sole issue is whether the facts satisfied the statutory standard, we ordinarily would be inclined to review the Tax Court's application of the law to the facts de novo. First Nat'l Bank v. Commissioner, 921 F.2d 1081, 1086 (10th Cir.1990) (tax court findings of "ultimate fact" derived from applying legal principles to subsidiary facts are subject to de novo review).

[7] However, Treas. Reg. § 1.165-1(d)(2)(i) provides that "[w]hether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances." This regulation was promulgated pursuant to the Secretary of the Treasury's express authority to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code. I.R.C. § 7805(a). It appears to reflect the longstanding maxim that losses claimed under I.R.C. § 165 are to be allowed or disallowed in accordance with practical or realistic considerations. See Estate of Scofield v. Commissioner, 266 F.2d 154, 160 (6th Cir.1959) (citing cases).

This court has long held that "a regulation promulgated by an administrative agency charged with the administration of an Act has

the force and effect of law if it is reasonably related to administrative enforcement and does not contravene statutory provisions." Joudeh v. United States, 783 F.2d 176, 180-81 (10th Cir.1986); see also In re LMS Holding Co., 50 F.3d 1526, 1528 (10th Cir.1995) (holding certain treasury regulations to have "the force and effect of law"). With regard to treasury regulations promulgated by the Secretary of the Treasury, the Supreme Court has specifically held that "[b]ecause Congress has delegated ... the power to promulgate 'all needful rules and regulations for the enforcement of [the Internal Revenue Code],' we must defer to [the Secretary's] regulatory interpretations of the Code so long as they are reasonable." Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 560-61, 111 S.Ct. 1503, 1507-08, 113 L.Ed.2d 589 (1991).

Even more pertinent to the case at bar, the Supreme Court has long held that " '[t]reasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.' " Cottage Sav. Ass'n, 499 U.S. at 561, 111 S.Ct. at 1508 (quoting United States v. Correll, 389 U.S. 299, 305-06, 88 S.Ct. 445, 448-49, 19 L.Ed.2d 537 (1967)). We note that Treas. Reg. § 1.165-1(d)(2)(i) has not been amended since 1977, and that I.R.C. § 165 (which Treas. Reg. § 1.165-1(d)(2)(i) interprets and implements) was substantially reenacted when the entire Internal Revenue Code was otherwise revised pursuant to the Tax Reform Act of 1986. We cannot conclude that Treas. Reg. § 1.165-1(d)(2)(i) is an unreasonable interpretation of I.R.C. § 165. We therefore think that Supreme Court precedent requires us to deem Treas. Reg. § 1.165-1(d)(2)(i) to have received congressional approval and therefore to have the effect of law.

Consequently, we conclude that "[w]hether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact...." Treas. Reg. § 1.165-1(d)(2)(i). Accordingly, we review the district court's findings in that regard under the "clearly

erroneous" standard. [FN5] Ramsay Scarlett & Co. v. Commissioner, 521 *1418 F.2d 786, 788 (4th Cir.1975) (tax court's determination of the reasonable foreseeability of a taxpayer's recovery of a loss reviewable under the "clearly erroneous" standard).

> FN5. A finding is "clearly erroneous" when "the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 541-42, 92 L.Ed. 746 (1948).

[8] In conducting our review, we note that Jeppsen bears the burden of proving his entitlement to the theft loss deduction. See Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281-82, 87 L.Ed. 1607 (1943) ("[A]n income tax deduction is a matter of legislative grace and ... the burden of clearly showing the right to the claimed deduction is on the taxpayer."). See also Parmelee Trans. Co., 351 F.2d at 628 (observing that taxpayer carries the burden of proving "no reasonable prospect" of recovery of the loss). We also note that Jeppsen's burden is high: he must prove that it could have been ascertained with reasonable certainty as of December 31, 1987 that this loss would never be recovered. See Treas. Reg. § 1.165-1(d)(3) ("[N]o portion of the loss with respect to which reimbursement may be received is sustained, for purposes of [I.R.C.] section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received.") (emphasis added). Thus, if Jeppsen's prospect of recovery was simply unknowable as of December 31, 1987, then Jeppsen would not be entitled to take the theft loss deduction in 1987.

[9][10] "A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor." Ramsay Scarlett, 61 T.C. at 811 (citations

omitted). Even a small chance of success might make the pursuit of legal remedies objectively reasonable, especially when the stakes are high. "A lawsuit might well be justified by a 10% chance [of success]." Parmelee Transp. Co., 351 F.2d at 628. Accord Rainbow Inn, Inc., 433 F.2d at 644; Exxon Corp. v. United States, 7 Cl.Ct. 347, 355 (1985), rev'd on other grounds, 785 F.2d 277 (Fed.Cir 1986), vacated after remand, 840 F.2d 916 (Fed.Cir.1988), and aff'd. after subsequent remand, 931 F.2d 874 (Fed.Cir.1991).

[11] The "reasonableness" of a taxpayer's prospect of recovery is primarily tested objectively, although a court may consider to a limited extent evidence of the taxpayer's subjective contemporaneous assessment of his own prospect of recovery. Ramsay Scarlett, 521 F.2d at 788 (citing Boehm v. Commissioner, 326 U.S. 287, 292-93, 66 S.Ct. 120, 123-24, 90 L.Ed. 78 (1945)). As the Boehm Court explained, "[t]he taxpayer's attitude and conduct are not to be ignored, but to codify them as the decisive factor in every case is to surround the clear language of ... [the applicable statute] with an atmosphere of unreality and to impose grave obstacles to efficient tax administration." [FN6] Boehm, 326 U.S. at 293, 66 S.Ct. at 124.

> FN6. Boehm did not involve the theft loss deduction at issue here, but rather a deduction available to holders of corporate stock that becomes worthless. However, the Fourth Circuit in Ramsay Scarlett analogized to Boehm in a very similar context, and we agree that the analogy is apt.

Under Treas. Reg. § 1.165-1(d)(2)(i), a taxpayer's prospects of recovery "may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim." Courts have occasionally suggested that the fact that a taxpayer files a lawsuit may give rise to an inference that the taxpayer has a reasonable probability of recovering his loss. See Dawn v. Commissioner, 675 F.2d 1077, 1078 (9th Cir.1982) (applying such an inference); Estate of Scofield v. Commissioner,

266 F.2d 154, 159 (6th Cir.1959) (filing lawsuit may give rise to inference of reasonable probability of recovery unless the lawsuit appears to have been specious, speculative, or wholly without merit); Parmelee Transp. Co., 351 F.2d at 629 ("[A] suit by a taxpayer will not operate as a presumption; at the most it leads to an inference which leads to an evaluation of the probabilities."). Several courts drawing an inference of "reasonable prospect of recovery" from the fact that the taxpayer has filed a lawsuit have been willing to consider lawsuits filed after the end of the tax year for which the theft loss deduction was claimed, so long as the taxpayer contemplated filing the lawsuit during that tax year. See Ramsay Scarlett, 61 T.C. at 812 (noting that *1419 taxpayer's retaining a lawyer and generally acting as though "gearing up for a contest" to vindicate legal rights during the year of the discovered loss may be evidence of reasonable certainty of recovery even though suit not formally filed until following tax year). See also Dawn, 675 F.2d at 1078-79 (citing cases).

[12] We agree that the fact that a taxpayer, in a given tax year, contemplates filing a suit to recover his losses may be considered in the mix of evaluating whether the taxpayer has a reasonable prospect of recovery. However, like any other subjective factor, this inference should not control the outcome of the case. See Boehm, 326 U.S. at 292-93, 66 S.Ct. at 123-24. As noted earlier, the primary analysis of whether there is a reasonable prospect of recovery on a claim for reimbursement of loss is an objective one.

[13] With these principles in mind, we review the tax court's determination in the present case. In support of its position that Jeppsen was not entitled to a theft loss deduction in tax year 1987 for the losses he suffered that year at the hands of stockbroker Barker, the tax court found that, by the end of 1987:(1) Barker had engaged in conduct that was both illegal and actionable; (2) Jeppsen knew what Barker had done; (3) Jeppsen began shopping for lawyers immediately and never at any time ceased attempting to recover his

money; (4) Barker's former employers PJ & H and E.F. Hutton were proper co-defendants, both of whom had more than sufficient assets available to satisfy any judgment awards against them; and (5) Jeppsen filed suit in March, 1988, several months before he filed his 1987 tax return.

As Jeppsen points out, several countervailing facts indicate that Jeppsen's prospects of recovery were never, until he prevailed, 100 percent. In particular, Jeppsen notes that: (1) both PJ & H and E F. Hutton consistently disclaimed any liability; (2) no lawyer contacted by Jeppsen would take his case on a contingency basis; and (3) several lawyers--including the firm he eventually retained--told Jeppsen that the case would be lengthy and expensive to pursue, with no guarantee of winning. Jeppsen asserts that these factors in the aggregate might have discouraged a reasonable person from bringing even a meritorious suit.

We appreciate the substantial risk that Jeppsen faced, and the significant effort that was required in order for Jeppsen to recover his stolen money. Indeed, faced with such obstacles, Jeppsen might reasonably have had decided to abandon his claims against Barker et al. in 1987. However, Jeppsen did not abandon his claims, in 1987 or ever. Rather, he sought in 1987 to determine whether and how he could recover his lost $194,000, and then steadfastly pursued all available legal remedies. Further, his suit was not based on a meritless legal theory, compare Rainbow Inn, Inc., 433 F.2d at 643-44, nor did his ultimate recovery depend on the outcome of some unforeseeable intervening event, compare S.S. White Dental Mfg. Co., 274 U.S. at 403, 47 S.Ct. at 600 (taxpayer not required to predict American victory in World War I and subsequent establishment of Mixed Claims Commission to award war reparations). Jeppsen's decision to pursue his stolen $194,000 before "writing it off" as lost was not an objectively unreasonable decision, even in the face of advice to the contrary from more than one lawyer. See Ramsay Scarlett, 61 T.C. at 795. Given the facts of this case,

including the amount of money at stake, the assets available to the co-defendants, and the possibility of obtaining some form of legal restitution, it could not be ascertained with reasonable certainty in 1987 that reimbursement for Jeppsen's losses would never be obtained. Yet such reasonable certainty is required by Treasury Regulation § 1.165-1(d)(3) in order for a taxpayer to be allowed to deduct a theft loss from taxable income.

Accordingly, we cannot say that the tax court clearly erred in sustaining the IRS's disallowance of Jeppsen's claimed 1987 theft loss deduction. The judgment of the tax court is therefore AFFIRMED.

PAUL KELLY, Jr., Circuit Judge, dissenting.

A.

The court places an insurmountable barrier on the taxpayer by requiring that he must *1420 prove with reasonable certainty, as of the end of the tax year, that the loss would never be recovered. Ct. Op. at 1418, 1419. According to the court, if the prospect of recovery is unknowable, then the taxpayer is not entitled to a deduction. Id. at 1418.

The "closed transaction doctrine," on which the court relies, does not require proof that the loss will never be recovered. Rather, it merely requires that reasonable prospects of recovery must be exhausted before a transaction will be considered closed and completed. Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 807, 1974 WL 2742 (1974), aff'd, 521 F.2d 786 (4th Cir.1975). A reasonable prospect of recovery exists "when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor." Id. at 811. Though the taxpayer had bona fide claims, as of December 1987, as discussed below a "substantial possibility" did not exist that the claims would be decided in his favor. The regulation cited by the court, Treas. Reg. § 1.165-1(d)(3), merely provides that

"if ... there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can be ascertained with reasonable certainty whether or not such reimbursement will be received." Thus, the taxpayer need only prove that it is reasonably certain that reimbursement will not be received; there is no requirement of proof that the loss will never be recovered. See United States v. S.S. White Dental Mfg. Co., 274 U.S. 398, 402-03, 47 S.Ct. 598, 600, 71 L.Ed. 1120 (1927) ("a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of eventual recoupment").

B.

"Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances." Treas. Reg. § 1.165-1(d)(2)(i). The Tax Court's finding in this case is reviewed under the "clearly erroneous" standard; "[a] finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 542, 92 L.Ed. 746 (1948). I am convinced that a mistake was committed when the Tax Court rejected the taxpayer's substantial and uncontroverted proof that, at the end of 1987, he lacked a reasonable prospect of later recovering his loss. See Rainbow Inn, Inc. v. Commissioner, 433 F.2d 640, 644 (3d Cir.1970) (reversing Tax Court's determination that a reasonable prospect of recovery existed).

Several well-established principles guide review. In determining whether a reasonable prospect of recovery exists, the relevant facts and circumstances are those that are known or reasonably could been known as of the end of the tax year for which the loss deduction is

claimed. See Halliburton Co. v. Commissioner, 946 F.2d 395, 400 (5th Cir.1991). "The only fair test is foresight, not hindsight." Scofield's Estate v. Commissioner, 266 F.2d 154, 163 (6th Cir.1959) (Tax Court's findings were clearly erroneous because factual conclusions and inferences drawn from the facts were based upon hindsight). Both objective and subjective factors may be examined. Boehm v. Commissioner, 326 U.S. 287, 292, 66 S.Ct. 120, 123-24, 90 L.Ed. 78 (1945); Ramsay Scarlett & Co. v. Commissioner, 521 F.2d 786, 788 (4th Cir.1975).

One of the facts and circumstances deserving of consideration is the probability of success on the merits of any claim brought by the taxpayer. While it is true that the filing of a lawsuit may give rise to an inference of a reasonable prospect of recovery, Dawn v. Commissioner, 675 F.2d 1077, 1078 (9th Cir.1982) the inference is not conclusive nor mandatory. Merely because a lawsuit with a ten-percent chance of recovery might be justified on grounds of principle does not mean that the lawsuit provides "a reasonable prospect of recovery." "The inquiry should be directed to the probability of recovery as opposed to the mere possibility." Parmelee Transp. Co. v. United States, 173 Ct.Cl. 139, ***1421** 351 F.2d 619, 628 (1965). A "remote possibility" of recovery is not enough; there must be "a reasonable prospect of recovery at the time the deduction was claimed, not later." Rainbow Inn, 433 F.2d at 644.

Surely a "reasonable prospect of recovery" encompasses an assessment of litigation risk at the time the deduction is claimed; given the uncertainty of trial and proof, there is a world of difference between pleading a claim, proving it and bringing it to judgment. Moreover, the obvious defenses to a claim cannot be ignored, nor can the financial capacity of a defendant to vigorously contest liability. At the Tax Court trial, the only testimony about the mechanics of the taxpayer's claim and the defenses raised was the attorney who prosecuted the claim, an expert in the field of securities litigation. No persuasive reason exists for disregarding his testimony.

See Ramsay Scarlett, 521 F.2d at 789 (Widener, J., concurring) ("The opinion of Sykes, admittedly a skilful attorney, as to the merits of the taxpayers' claims against the bank, was obviously relevant in any kind of objective inquiry."). Although the government, with 20-20 hindsight, suggests various theories of liability that should have been apparent in 1987, most of the telling facts were developed later and the difficulty of successful proof on controverted facts makes the outcome far less apparent. See, e.g., Hotman v. Lowell H. Listrom & Co., 808 F.2d 1384, 1385 (10th Cir.1987) (directed verdict in favor of defendants on churning claim).

Here, despite the taxpayer's belief that he had been wronged, virtually no evidence existed to substantiate the taxpayer's claims as of December 31, 1987. From a procedural perspective, the taxpayer had signed an account agreement with PJ & H that contained an arbitration clause that would limit discovery, so it was necessary to mount an attack on the validity of the arbitration clause in federal court (an attack that would ultimately prove unsuccessful), in part to obtain the liberal discovery allowed by the federal rules. The scope of discovery that was ultimately allowed in federal court greatly benefitted the taxpayer, but that scope was fortuitous.

The merits of the case depended not only upon credibility, but also a determination of whether PJ & H could be responsible for the activities of its broker. PJ & H denied liability and responsibility for its broker, despite an admission by the branch manager that the unauthorized discretionary trading was improper. The parties have stipulated that the broker's actions constituted theft under Utah law, and only if taxpayer could prove that the broker's conduct was in the course and scope of his employment would there be vicarious liability based upon respondeat superior. See Jackson v. Righter, 891 P.2d 1387, 1391 (Utah 1995); Birkner v. Salt Lake County, 771 P.2d 1053, 1056-59 (Utah 1989). Several courts have held that employee theft is not within the course and scope of employment, see, e.g., Los Ranchitos v. Tierra Grande, Inc., 116 N.M. 222, 861 P.2d 263, 268

(1993); B.B. Walker Co. v. Burns Int'l Security Servs., 108 N.C.App. 562, 424 S.E.2d 172, 174, review denied, 333 N.C. 536, 429 S.E.2d 552 (1993); but see Richards v. Attorneys' Title Guaranty Fund, Inc., 866 F.2d 1570, 1572-73 (10th Cir.) (applying Restatement (Second) of Agency § 261 (1958); vicarious liability for agent's theft), cert. denied, 491 U.S. 906, 109 S.Ct. 3189, 105 L.Ed.2d 697 (1989), and the Utah courts have recognized that the issue may be decided as a matter of law when the employee's conduct is so clearly outside the scope of employment that reasonable minds could not differ, see Jackson, 891 P.2d at 1391; Birkner, 771 P.2d at 1057. Given the parties stipulation of theft, the taxpayer had a formidable legal barrier to overcome.

As of December 1987, PJ & H also could be expected to defend on the basis that (1) the taxpayer was a sophisticated, aggressive investor who authorized the transactions and sought return without regard for risk, (2) the taxpayer had received confirmations and account statements and therefore had ratified the transactions, and (3) the taxpayer was merely trying to avoid the consequences of the 1987 market fall. I am persuaded that all of these objective factors viewed as of December 1987, together with the taxpayer's statement on cross-examination that he pursued the matter as a moral issue, despite advice that his chances were not very good, Aplt.App. at 155, render the Tax Court's finding clearly erroneous.

*1422 I would reverse and therefore respectfully dissent.

T.C. Memo. 1995-342

UNITED STATES TAX COURT

HARV L. JEPPSEN, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 2671B-92 Filed July 26, 1995

Shawn D. Turner and R. Bret Jenkins, for petitioner.
J.A. Lonata and James B. Ausenbauch, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SWIFT, Judge: Respondent determined a deficiency of $61,298 in petitioner's 1987 Federal income tax and an addition to tax under section 6651 of $9,735. After concessions by respondent, the issue remaining for decision is whether petitioner is entitled to a theft loss deduction for 1987 in the amount of $166,627.

Unless otherwise indicated all section references are to the Internal Revenue Code in effect for 1987, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. At the time he filed his petition, petitioner resided in Farmington, Utah.

Petitioner graduated from high school but never attended college. In the mid-1980's, petitioner was a carpet installer and owned a floor covering business from which he saved a substantial sum of money. Petitioner planned on eventually using this money to buy a home or to reinvest in his floor covering business.

In February or March of 1986, petitioner decided to invest some of the money he had saved through George Barker (Barker), a securities dealer with the brokerage firm of E.F. Hutton Group, Inc. (E.F. Hutton). Petitioner had no prior experience investing in stocks or stock options.

Barker knew that petitioner was not experienced or sophisticated in securities investments. Barker, without petitioner's knowledge, falsified records of petitioner's new E.F. Hutton account to reflect that petitioner was an experienced investor in stocks and stock options. Barker also obtained petitioner's signature for the purpose of establishing petitioner's E.F. Hutton account as a discretionary account in order to authorize Barker to transact securities trades in the account.

The discretionary nature of petitioner's E.F. Hutton account, however, never received the required approval by management of E.F. Hutton, but Barker immediately began

to "churn" petitioner's investments by purchasing and selling various call options.[1]

In September of 1986, Barker left E.F. Hutton and began working at the brokerage securities firm of Piper, Jaffray and Hopwood (PJ&H). In December of 1986, Barker informed petitioner of his new employment with PJ&H, and he asked petitioner to transfer petitioner's E.F. Hutton account to PJ&H so that Barker could continue to act at petitioner's broker. Acting on Barker's request, petitioner transferred the securities investments in his E.F. Hutton account to an account at PJ&H.

Barker requested petitioner to then open a margin account, and Barker instructed petitioner to sign a PJ&H margin account authorization form. Barker, however, did not inform petitioner that a margin account would give Barker authority to purchase securities on behalf of petitioner on credit.

Documents required by PJ&H to establish petitioner's PJ&H account as a discretionary account were never signed by petitioner. Despite the fact that the discretionary nature of petitioner's PJ&H account was not properly established, Barker treated petitioner's account at PJ&H as a discretionary account, and Barker purchased highly

---

[1] "Churning" occurs when a broker engages in excessive trading in disregard of the customer's investment objectives solely for the purpose of generating commissions. Call options are options to buy a specified number of securities at a specified price at a specified filing date.

speculative penny stocks for petitioner's PJ&H account, including stock in Rhodes Charter House Group. The price of the stock in Rhodes Charter House Group was then manipulated by Barker and by his business associate, Richard Hermansen (Hermansen), apparently through repeated purchase and sales of the stock.

Hermansen was later indicted on over 40 Federal criminal count, including securities fraud, mail fraud, and tax fraud.

Barker also began churning blue chip stocks in petitioner's PJ&H account. An examination of petitioner's PJ&H account using the Securities and Exchange Commission Looper Analysis[2] showed per se churning of the stocks in petitioner's account.

In approximately July of 1987, when petitioner showed one of his PJ&H account statements to his father, petitioner became aware of problems with his PJ&H account. After examining the statements, petitioner's father informed petitioner that the existence of a minus sign next to one of the numbers on the account statement might indicate that Barker was purchasing stock for petitioner on credit. Petitioner then asked Barker about the transactions in petitioner's PJ&H account, at which time Barker informed petitioner that because the account constituted a margin account, Barker had been purchasing securities for the

---

[2] The Looper Analysis is a method developed by the Securities and Exchange Commission to evaluate the level of churning in securities brokerage accounts.

account on credit. Petitioner immediately told Barker to close the margin account.

When petitioner received the next monthly account statement from PJ&H, petitioner noticed that the margin account had not been closed. Petitioner again instructed Barker to close the margin account. Barker, however, continued to sell certain stocks and stock options in petitioner's margin account, and he failed to close the account.

On October 7, 1987, petitioner specifically instructed Barker to immediately liquidate to cash the entire balance of his PJ&H account, except for a mutual fund. Barker assured petitioner that the account would be liquidated, but Barker told petitioner that it would take a number of days to complete the liquidation. The parties have stipulated that, in fact, liquidation of petitioner's account could and should have been accomplished in one day.

In attempting to liquidate part of petitioner's PJ&H account, Barker tried to sell a call option. PJ&H's Minneapolis office questioned the "naked" sale of the call option. Partly because of its sophisticated nature, the attempted sale of the call option was regarded as an extremely risky transaction, and PJ&H's Minneapolis office requested that petitioner sign a special authorization letter to give Barker authority to sell the call option. Instead of waiting for petitioner to sign an authorization letter, Barker forged petitioner's signature and altered other documents in petitioner's PJ&H file to falsely reflect that petitioner's approval had been obtained to sell the call option.

Most of the problems with petitioner's PJ&H account were brought to petitioner's attention after the stock market fell on October 19, 1987. On this date, known as "Black Monday", the Dow Jones Industrial Average decreased in value by 22.6 percent. As a result, petitioner's PJ&H account declined in value by approximately $194,000. The week after October 19, 1987, petitioner met with Don Larkin (Larkin), PJ&H's branch manager and Barker's supervisor, to discuss losses petitioner had suffered in his PJ&H account. Larkin told petitioner that because of the nature of petitioner's margin account and the losses petitioner had suffered, all securities in petitioner's PJ&H account would have to sold to cover the losses.

During the above meeting, petitioner informed Larkin that petitioner had been unaware of many of the transactions that had occurred in his PJ&H account. Larkin admitted to petitioner that Barker's actions with respect to petitioner's PJ&H account had been improper. Specifically, Larkin admitted that petitioner had never properly authorized discretionary investing by Barker on his behalf.

On October 26, 1987, Larkin formally reprimanded Barker for the unauthorized discretionary trading in petitioner's PJ&H account. Larkin, however, denied any liability of PJ&H for Barker's actions.

At the end of October of 1987, petitioner approached an attorney about the possibility of investigating Barker's actions with regard to petitioner's brokerage accounts at E.F. Hutton and PJ&H. The attorney's investigation resulted in the receipt by petitioner of a letter dated December 21,

1987, from the law firm of Van Cott, Bagley, Cornwall, and McCarthy, PJ&H's legal counsel, which denied on behalf of PJ&H any responsibility for petitioner's securities losses in his PJ&H account and which claimed that petitioner was merely a frustrated investor who had lost money as a result of the October 19, 1987, fall in the stock market. At that time, the attorney did not pursue, on petitioner's behalf, any legal action against PH&H or Baker.

At about this time, petitioner transferred his securities investments in the PJ&H account to an account with a securities broker by the name of Franklin Richards (Richards).

In December of 1987, petitioner contacted attorneys with the Salt Lake City law firm of Callister, Duncan, and Nebeker about representing petitioner in an action to recover petitioner's securities losses. The attorneys agreed to represent petitioner but required that petitioner pay the law firm on an hourly basis and not on a contingency basis. The attorneys informed petitioner that there was a possibility that petitioner could prevail in a lawsuit but that the lawsuit would be long and costly. Petitioner informed the attorneys that he wished to proceed with some type of legal action to recover his losses.

In March of 1988, petitioner's new attorneys filed on petitioner's behalf a complaint in the U.S. District Court for the District of Utah (District Court). The complaint alleged violations of Federal and State securities laws and common

law fraud by E.F. Hutton, PJ&H, and Barker. PJ&H never filed an answer to the complaint.[3]

On May 9, 1988, PJ&H filed a motion to compel arbitration of the case. On December 27, 1989, afer allowing the parties to conduct some discovery, the motion for arbitration was granted by the District Court.

During the arbitration proceedings, the law firm of Callister, Duncan, and Nebeker agreed to change its fee arrangement with petitioner to a contingency fee basis. By that time, petitioner had paid the law firm approximately $180,000 in legal fees and costs.

On March 17, 1993, after 3 years of additional discovery and negotiations in the arbitration proceedings, petitioner filed a claim with the National Association of Securities Dealers Arbitration Panel (Arbitration Panel). On January 11, 1994, the Arbitration Panel rendered a judgment in favor of petitioner against PJ&H, Barker, and Larkin in the amount of $603,000. The Arbitration Panel also included in the judgment punitive damages awards in favor of petitioner against Barker of $250,0900 and against Larkin of $250,000.

The judgment of the Arbitration Panel was appealed to and affirmed by the District Court, but an appeal was taken to the U.S. Court of Appeals for the Tenth Circuit. Before the Tenth Circuit rendered a decision on the appeal,

---

[3] Although E.F. Hutton was named as a defendant, E.F. Hutton was later dismissed as a defendant.

the parties apparently entered into a confidential settlement of the dispute.

Petitioner and respondent stipulated that Barker's actions against petitioner constituted a theft for purposes of Utah State law.

On his 1987 Federal income tax return, petitioner claimed a theft loss deduction in the amount of $166,627 relating to the losses he incurred in his E.F. Hutton and his PJ&H brokerage accounts. Respondent disallowed the claimed theft loss deduction on the basis that petitioner had a reasonable prospect of recovering his loss as of the close of 1987.

OPINION

Section 165(a) allows a deduction for any loss "sustained" during the taxable year and not compensated for by insurance or otherwise, including the losses arising from theft. Sec. 165(c)(3).

A loss arising from theft is treated as sustained during the taxable year in which the taxpayer discovers the theft loss and in which the loss is evidenced by a "closed and completed" transaction. Sec.165, sec. 1.165-1(d)(1), Income Tax Regs. Whether there has been a closed and completed transaction evidencing the loss may depend on the taxpayer's prospects of receiving reimbursement for the loss. Sec. 1.165-1(d)(2)(i), Income Tax Regs. If at the close of the year there exists a claim for reimbursement "with respect to which there is a reasonable prospect of recovery", no portion

theft loss will be considered to have been sustained in that year, and the theft loss will not be considered sustained until it becomes reasonably certain that reimbursement will not be received. Sec. 1.165-1(d)(3), Income Tax Regs.

Whether the taxpayer, as of the close of a year, has a reasonable prospect of recovering a theft loss depends upon the facts and circumstances of each case. Boehm v. Commissioner, 326 U.S. 287, 292-293 (1945); Dawn v. Commissioner, 675 F.2d 1077, 1078 (9th Cir. 1982), affg. T.C. Memo. 1379-479; Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974).

One of the factors that is relevant in the determination of whether a taxpayer has a reasonable prospect of recovering a theft loss is whether the taxpayer filed a lawsuit to recover the loss. Dawn v. Commissioner, supra, at 1078; Estate of Scofield v. Commissioner, 266 F.2d 154, 159 (6th Cir. 1959), affg. in part and revg. in part 25 T.C. 774 (1956). Even if a lawsuit was not filed as of the close of the year for which the taxpayer claims a theft loss deduction, the filing of a lawsuit soon after the close of the year suggests that the taxpayer did not consider the loss closed and completed. Dawn v. Commissioner, supra at 1078; National Home Prods., Inc. v. Commissioner, 71 T.C. 501, 526 (1979).

The loss deduction need not be postponed if the potential for success of a claim is remote or nebulous. Ramsay Scarlett & Co. v. Commissioner, supra at 811. Also, where the financial condition of the person against whom a claim is filed is such that no actual recovery could realistically be expected, the loss deduction need not be postponed. Gottleib Realty Co. v. Commissioner, 28 E.T.A.

418, 420-421 (1933). If the taxpayer's claim is not speculative or wholly without merit, and if the taxpayer believes that the chance of recovering the loss is sufficiently probably to warrant bringing a lawsuit and prosecuting it with reasonable diligence to a conclusion, the taxpayer generally should wait until the conclusion of the lawsuit to claim the theft loss deduction. Estate of Scofield v. Commissioner, supra at 159.

The test for determining whether the taxpayer had a reasonable prospect of recovering the theft loss is primarily an objective test, Ramsay Scarlett & Co. v. Commissioner, supra at 812, but he taxpayer's subjective belief as of the close of the year that there is a reasonable prospect of recovering the loss is also an important and relevant factor. Boehm v. Commissioner, supra at 292-293. Also relevant is the amount of time and money spent by the taxpayer investigating and prosecuting the claim and whether the taxpayer ultimately recovered the loss. National Home Prods., Inc. v. Commissioner, supra at 526; Gale v. Commissioner, 41 T.C. 269, 276 (1963); Huey v. Commissioner, T.C. Memo. 1985-348.

As stated, petitioner and respondent agree that under Utah State law the activities of Barker constituted a theft. Petitioner and respondent, however, disagree as to whether petitioner was entitled to a theft loss deduction for 1987, the year in which the theft was discovered.

Petitioner emphasizes that, as of the close of 1987, he had not filed a lawsuit against Barker or the brokerage firms for which Barker worked. The law firm representing petitioner initially refused to accept petitioner's case on a

contingency fee basis, and PJ&H initially denied any responsibility for petitioner's losses. Petitioner argues that based on these facts, among others, any claim that petitioner may have had as of the close of 1987 was speculative, and any prospect of recovering the loss was remote.

We agree with respondent. As of the close of 1987, petitioner had already met with his attorneys and had decided to file a claim. The fact that the law firm refused to accept petitioner's case on a contingency fee basis does not necessarily make petitioner's prospects of recovery unreasonable. Even though extensive additional discovery may have been necessary to prove petitioner's claim, petitioner's attorney testified that from his initial review of petitioner's case in January 1988, the evidence then available clearly showed that misrepresentations had been made by Baker to petitioner, that Barker had illegally churned the securities in petitioner's account, and that Barker had conducted transactions with respect to petitioner's account without petitioner's authorization. This evidence, which was available to petitioner and to his attorneys as of the close of 1987, included petitioner's own testimony and the PJ&H account statements that showed unauthorized margin trading. Petitioner's claim, as of the close of 1987, was also supported by the admission of Larkin that Barker's actions had been improper.

In light of the evidence in this case, we conclude that petitioner's claim against Barker, as of the close of 1987, was not speculative and that petitioner's prospects of recovering the theft loss were not remote or nebulous. We also conclude that because of the employee/employer

relationship between Barker and PJ&H, petitioner also had a reasonable prospect of prevailing on a claim against PJ&H. See Clover v. Snowbird Ski Resort, 808 F.2d 1037? (Utah 1991) (employer held liable for torts of employee under doctrine of respondeat superior); Krukiewicz v. Draper, 725 F.2d 1349 (Utah 1986); Phillips v. JCM Dev. Corp., 666 P.2d 876 (Utah 1983); see also SEC v. Management Dynamics, Inc., 515 F.2d 801 (2d Cir. 1975) (broker-dealer held liable under 1934 Securities Act as a "controlling person").

Although the parties offered no evidence regarding Barker's financial ability to satisfy petitioner's claim against him, PJ&H would appear clearly to have the financial ability to satisfy petitioner's claims. PJ&H is a national brokerage firm that was listed on the New York Stock Exchange in 1987. For a company to have been listed on the New York Stock Exchange at that time, the company had to have net assets of $18 million. NYSE Listed Co. Manual Regs., sec. 102.01.

The evidence, viewed as a whole, supports our conclusion that petitioner, as of the close of 1987, had a reasonable prospect of recovering his theft loss. We sustain respondent's disallowance of the theft loss deduction petitioner claimed for 1987.

Decision will be entered under Rule 155.